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SUBJECT: BABY STEPS: EXTERNAL COMMERCIAL BORROWING NORMS AND DEBT
INVESTMENT LIMITS RELAXED

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11. (U) The Reserve Bank of India (RBI) and Ministry of Finance (MoF) relaxed norms on external commercial borrowings (ECBs) on May 30. The announcement relaxed restrictions in three distinct areas. First, the limit on borrowings by companies for rupee expenditures was raised from USD 20 million to USD 50 million with companies seeking loans for infrastructure projects able to borrow USD 100 million. The USD 500 million per company per year limit for overseas borrowings in foreign currencies without rupee expenditures under the Automatic Route - requiring no RBI approval -- was kept unchanged. Also left unchanged were the restrictions on Indian banks serving as guarantors on foreign loans. Second, the cost ceilings (caps on interest rate charges) for ECBs were also raised. The ceiling on 3 to 5 year maturity loans was raised from 150 to 200 bps over the London Interbank Offered Rate (LIBOR), while the cap on loans over 5 years was raised from 250 to 350 bps over LIBOR. (Note: By limiting the amount over LIBOR at which companies may borrow, the RBI was able to restrict lending to companies with high credit ratings, i.e. large firms. Raising this ceiling could potentially expand the number of companies eligible for credit, especially as interest rates have risen. End note.) Third, the overseas investment limit on corporate bonds was raised to USD 3 billion from USD 1.5 billion, and on government bonds to USD 5 billion from USD 3.2 billion.

12. (U) Salim Gangadharan, Chief General Manager-in-Charge of Foreign Exchange at the RBI told Congenoff that the changes were designed to help all sectors, not only the Small and Medium Enterprise (SME) sector. Capital flows had moderated over the last several months, so after a review of the macro-economic conditions and talking with industry players, the RBI and MoF decided to raise ECB limits. He commented that depending on how markets and companies respond, these limits could be raised or lowered after another 3-4 months. He said there was great interest from FIIs to invest in the debt sector, which is why the overseas investment limit for the bond market has been raised as well.

13. (U) Dr. Atsi Sheth, Chief Economist of Reliance Capital, informed Congenoffs that the steps taken were expected but not monumental changes, and might help only at the margins. The impetus for the changes was that the Indian rupee was depreciating, the current account deficit was widening because of escalating oil prices, and capital inflows had slowed down because the correction in the Indian equity market. In other

words, the RBI thought it would be easier for the Indian economy to absorb the increased capital flows resulting from the loosened restrictions and be balanced by the increased outflows because of high oil prices. Ashish Ghiya, Managing Director of Derivium Securities, a bond trading platform, echoed the view that these moves were made more to manage foreign exchange flows than help the overall economy. He commented that last year, too many dollars flowed in so ECB restrictions were tightened; but this year with inflows slowing down the restrictions are being loosened to encourage more dollar inflows to balance the oil account. However, he did not see an immediate dollar rush into India.

¶4. (U) Sheth pointed to the lifting of the overseas investment limit on corporate and government bonds as being particularly smart. Her conversations with foreign institutional investors (FII) confirmed RBI's statement that FIIs are increasingly looking at Indian fixed income markets as an attractive investment alternative to the volatile equity markets. (Note: Most market participants and several Government of India High-Powered Expert Committee Reports point to greater FII participation as a prerequisite for corporate bond market development. End Note.) Pankaj Vaish, Managing Director and Head of Equities and Fixed Income at Lehman Brothers, also agreed but thought that the overseas investment limit needed to be raised to at least USD 25 billion to attract significant FII interest in the Indian debt market. Sheth countered that while the limits are still tiny compared to the mountain of foreign capital available to invest in the fixed income markets if restrictions were abolished, the RBI was wary of doing so. She noted that the GoI and RBI had thoroughly studied the Russian and Asian financial crises of the late 1990s which were led by volatility in their fixed income markets; she believes that given this history and the RBI's traditional caution, the RBI will not allow the complete liberalization of or significant increases of overseas investment limits in Indian fixed income

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markets.

¶5. (U) Sridhar Prabhu, a fixed income analyst at CRISIL, a local bond ratings agency, welcomed the hiking of the cost ceiling on ECBs. He stated that this was a badly needed move because previous cost ceilings were not attractive for lenders. He described the new restrictions as "more reasonable." Vaish of Lehman Brothers disagreed with the CRISIL view, pointing out that the new cost ceilings are still not realistic for the market. He claimed that SMEs are being quoted rates of LIBOR + 500 bps, making ECBs beyond their reach under the new ceiling.

¶6. (U) P.V. Rao, Senior Vice President & Head-Resources of IL&FS, noted that while the relaxation in ECB limits is "good news" especially for companies engaged in infrastructure activities, the restrictions on end-use remain in place. The increased foreign borrowing available through ECBs therefore cannot be used for corporate lending or investment in the capital market, for acquisitions of Indian companies except by banks and eligible financial institutions, for replacing working capital, financing real estate, or repaying existing rupee loans. Rao also pointed out that ECBs under the new caps fall under the approval route and will require prior approval of the RBI. In a research note, Shuchita Mehta, senior economist at Standard Chartered, felt the RBI would use the approval process to ensure ECBs do not flood in.

¶7. (U) Representatives from the project finance groups of Government-owned State Bank of India (SBI) and Industrial Development Bank of India (IDBI) also gave positive assessments of the moves, particularly the relaxation of interest rate ceilings. Both thought the increased ceiling for infrastructure projects was overdue, and will help address the infrastructure bottlenecks plaguing the Indian economy. However, the representative of IDBI expressed disappointment that Indian banks are still prevented from co-guaranteeing loans with External Credit Agencies.

18. (U) Comment: While many market players obviously hoped for more from this move, all recognized that the RBI's changes are a step in the right direction. Whether these steps result in increasing capital inflows, either through ECBs or the bond market will be closely watched. End Comment.
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